

APPENDIX

Notes for FOMC Meeting

April 22, 1980

Scott E. Pardee

Since the March 18 meeting of the FOMC, there has been a turn in fortunes for the dollar in the exchange market, roughly coinciding with the turn in interest rates here in the United States. As long as interest rates were rising, the dollar was in demand. Corporations shifted into dollars, OPEC funds were kept in dollars rather than diversified heavily into other currencies, and professional dealers went long of dollars both to profit if the dollar should continue to rise and to gain a few basis points on dollar balances as a result of the favorable interest differentials. The heavy demand for dollars continued through the quarter-end and into early April. At the peaks, compared with the lows of earlier this year, the dollar had risen by 16-1/2 percent against the D-mark, [unintelligible] against the Swiss franc, and 10 percent against the Japanese yen.

As before, we at the Desk continued to acquire marks from the Bundesbank and from other correspondents to restore Treasury balances. By late March, early April we were much more openly buying marks as well as Swiss francs in the market. In part this was a cooperative gesture to join with the other central banks in intervening to avoid a disorderly swing of the dollar in an upward direction. But as a practical matter we were amassing all the resources we could in advance of the next bout of selling pressure on the dollar.

We did not have long to wait. By early April many market participants began to feel that the rise of the dollar was overdone and that prevailing dollar rates would be unsustainable. Market participants knew that foreign authorities were becoming increasingly defensive about both the high U.S. interest rates and the rise of the dollar against their currencies. German officials made no bones about their concern. The German Finance Ministry openly solicited investments by OPEC central banks to help finance Germany's current account deficit and bolster the D-mark. The Bundesbank tightened the German money market to the degree that market participants fully expected a further rise in official interest rates in Germany. The market view also was that by the latest indicators the U.S. inflation rate and trade deficit remained too large to justify such a strengthening of the dollar on the basis of the fundamentals alone. And at some point market participants expected U.S. interest rates to come down. Although the U.S. economy was showing signs of softening, exchange market participants feared that, as occurred in the recession of 1974-75, interest rates here would decline sharply before the U.S. economy would show demonstrable progress on inflation and the current account deficit.

Consequently, at the first signs that interest rates in the United States might be topping off, the dollar came under heavy and immediate selling pressure. Following the Easter weekend hiatus, beginning on April 8, the dollar dropped precipitously across the board as traders scrambled to get out of their long dollar positions. There were few willing buyers. Against the mark the dollar dropped in two days from 1.98 to 1.88, or more than 5 percent. Similar percentage changes were recorded against other major currencies. To cushion the decline, the Desk intervened in size in marks and Swiss francs. In addition, since the mark was weak relative to the French franc within the EMS, we also intervened as a seller of French francs so as not to

add to strains within the European joint float. The Germans were obviously pleased with the turn of events. The Bundesbank gave us little help in intervention but at least decided not to tighten monetary policy any further for the time being. Thus for the moment at least we were able to avoid the potentially dangerous situation for the dollar of having German official interest rates move up while our interest rates were coming down.

The Iranian situation was also a factor in the dollar's decline, particularly since the unilateral U.S. actions pressing Iran to release the hostages were taken as bearish for the dollar. More recent reports that we might receive some help from countries in Europe or from Japan are taken as now bullish for the dollar, since the other countries are seen as risking their oil supplies from Iran and export prospects in that country.

For the past week, the exchange market has been exceedingly nervous, with volatile rate movements reflecting concerns about interest rates and the Iranian situation. On balance, the dollar is trading roughly midway between its highs and lows of the year.

Although many commentators believe that a U.S. recession may be under way, the major indicators that are of particular interest to foreign exchange traders--those on inflation and the trade balance--have shown no great improvement for the United States as yet. By contrast, in some other countries there are signs that upward pressure on prices may be abating, particularly in Germany and Switzerland. I won't belabor the point but I would be remiss if I did not report that hardly a conversation with market participants goes by without our being told that the outlook for the dollar depends heavily on whether the Federal Reserve continues to show resolve in combating inflation and, ultimately, on how successful we are in our efforts.

To summarize our operations, during the period we operated in four currencies. In marks the Desk bought a total of \$1.2 billion equivalent, of which \$1 billion was for the Treasury and the rest for the Federal Reserve. Most of this was in March. In intervention in April we have sold a total of \$1 billion of marks shared about equally with the Treasury. For the System we at first used mark balances but then reverted to use of the swap line with the Bundesbank. Our drawings on the Bundesbank currently stand at \$290 million equivalent. In French francs, our intervention was financed by \$74 million of drawings under the System's swap line with the Bank of France. In Swiss francs, we purchased \$142 million for System balances in late March and early April and later in intervening when the dollar came under selling pressure we sold \$55 million out of balances. In Japanese yen, we purchased an additional \$70 million early in the period for balances; later on the yen also firmed against the dollar but we did not intervene as a seller of yen.

REPORT OF OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

Pursuit of reserve targets consistent with the Committee's money and credit growth objectives since the March meeting initially caused the Account Management to press hard on the availability of reserves, as it looked as though money growth would exceed the desired path. The money market firmed sharply and short-term rates pushed to new records. The Federal funds rate, which had been averaging a little over 16 percent in mid-March, climbed toward the Committee's 20 percent upper bound, reaching a record weekly average of about 19 3/8 percent in the week ending April 2. By that time, it was becoming progressively more evident that monetary growth in the March-April period was falling short of earlier expectations, and well short of path growth rates, so that pursuit of reserve objectives led to a let-up in pressures and decline in rates. In the latest full week the average funds rate came down to about 18 3/8 percent and most recent trading--yesterday--was in the 17-18 percent area.

Largely reflecting the weakening performance of the aggregates, it is currently estimated that total reserves in the five statement weeks ending tomorrow will average about \$430 million below path--in contrast to the slight overshoot estimated near the end of March. Nonborrowed reserves should come out much closer to their path--perhaps on the order of \$100 million below for the five week average. The path for nonborrowed reserves,

moreover, was raised explicitly by \$150 million early in the period in relation to the path for total reserves, in recognition that the initially assumed borrowing level of \$2,750 million was too high in light of bank attitudes after the mid-March imposition of a surcharge on borrowings by large banks with frequent recourse to the window. As described in the Blue Book the nonborrowed path was implicitly raised even further, by several hundred million, as sizable and growing amounts were being borrowed by a large troubled bank that was having difficulty funding itself. That bank borrowed roughly \$200 million in the first full week of the period, and worked up to around \$600 million in the current week. Since the steady borrowings by that bank were not of a short-term adjustment character and did not entail the usual pressures for prompt repayment, they are more appropriately regarded as nonborrowed reserves.

Total discount window borrowing, including that particular bank, averaged around \$2.7 billion in the first week of the period, and slipped off to around \$2.3 billion in the next three weeks, ending April 16. When we reviewed the reserve paths last Friday, it was calculated that achievement of the average nonborrowed reserve path for the full five weeks would imply a need for borrowing in this final week of the period of only about \$1.25 billion--a rather abrupt decline from the recent \$2.3 billion level, especially when one considers the large and growing borrowing by that special bank noted earlier. A strong push to achieve that arithmetically derived level of nonborrowed reserves this week could have accentuated sharply the already much more buoyant tone

developing in the money and credit markets, and caused serious questioning of the System's resolve to carry through its restraint program. Accordingly, we have been content in our operations so far this week to achieve a somewhat lower level of nonborrowed reserves that might be consistent with borrowings in the \$1.7 billion area--about half-way between the recent \$2.3 billion level and the arithmetically derived \$1.25 billion. In fact, though, despite ample reserve provision by the Desk, borrowing has remained surprisingly high so far this week, averaging about \$2.5 billion through yesterday.

In meeting reserve path needs during the past month, the System made substantial outright securities purchases, totaling some \$4 1/4 billion, and requiring, as you know, a temporary enlargement in the usual \$3 billion limit on changes between meetings in outright holdings. One reason for the unusually large need was the rise in marginal reserve requirements because of the March 14 program which lowered the base and raised the requirement percentage. Those enlarged requirements were incorporated into the total and nonborrowed reserve paths. The outright purchases included some \$950 million in Treasury coupon issues, about \$670 million of Federally sponsored agency issues, and over \$2.6 billion in Treasury bills. Short-term reserve adjustments were made as usual with repurchase agreements and matched sale-purchase transactions in the market, while matched sales were also arranged nearly every day with foreign accounts.

Interest rates generally rose in the early part of the period and then fell back--declining fairly moderately, by recent

standards, in the case of the Federal funds rate, but dropping quite dramatically for most marketable instruments. Three-month Treasury bills, for example, were auctioned at about 15.05 percent just before the last meeting, at a record 16.53 on March 24 and at 12.73 percent yesterday. Six-month bills, on which the money market certificate rates are based, sold at 14.95 just before the last meeting, a high of 15.70 on March 24, and 11.89 percent yesterday. Treasury coupon issues, similarly, rose around 1 percentage point in yield from the start of the period to March 24, but then plummeted to end the period with net declines of around $2\frac{1}{4}$ - $3\frac{3}{4}$ percentage points for intermediate maturities and $1\frac{1}{2}$ - $2\frac{1}{4}$ percentage points for long-term issues. The prime rate, which was around $18\frac{1}{4}$ - $18\frac{1}{2}$ at the start of the period, has come off only modestly from its 20 percent peak to $19\frac{1}{2}$ percent for most banks.

The yield gains early in the interval reflected a combination of firm restraint on reserve availability and concern about enlarged Treasury cash needs. The later decline developed as the market was impressed by signs of weakening economic activity and unexpected declines in money supply. Even inflation psychology seemed to be dented a bit by the dramatic break in silver and some other commodity prices. Market participants now accept almost universally that the economy is heading into recession, though views are mixed on its depth and duration, and there is still much skepticism as to when we may see abatement in broad measures of inflation. There is also widespread acceptance of the view that the peaks in interest rates have been seen, but again a range of

opinion on how far they may fall, and when. A number of participants feel that the steep descent of recent days may have been overdone for the time being, and that some rates could rise again though not to the peaks of a few weeks ago. Still the psychology is markedly different from a month ago, as evidenced by dealer positions in over-1-year issues: a net short position of nearly \$500 million just before the last meeting, and a net long position of \$1 billion last Friday.

As to the funds rate, participants seem to be seeking to gain a sense of likely near-term ranges of variation. There is acceptance of having come down from the near 20 percent area, but System actions to provide reserves in the last few days, when funds were around 18 1/4-18 1/2, have left some uncertainty, and in some cases concern that the Fed may be weakening its anti-inflationary stance--notwithstanding the evidence of a softening economy and weak monetary aggregates.

The exceptionally large Treasury cash needs of the past month--over \$20 billion--should abate substantially in the month ahead. Regular weekly and monthly auctions are continuing to take new cash additions, however, and the quarterly refunding to be settled May 15, with a moderate \$1.7 billion of the maturing issue held by the public, provides an opportunity for the Treasury to tap the intermediate- and longer-term markets for additional funds. The System Account holds a substantial \$5.2 billion of that May 15 maturity and we would expect to exchange it for new issues roughly in line with the proportions offered to the public, though weighted a bit toward the shorter end as we have done with other recent refundings.

James L. Kichline
April 22, 1980

FOMC Briefing

The Commerce Department has estimated that real GNP advanced a little further in the first quarter. However, information available on economic activity during the quarter indicates that the gain on average was attributable to developments early, and that activity turned down appreciably in the latter part of the quarter. At the present time there is pervasive evidence of weakness in the economy. The current staff projection takes account of incoming information since the last Committee meeting and more importantly incorporates the recent anti-inflation program, including the imported oil levy and fiscal and monetary actions. The forecast now indicates a larger drop in activity this year as well as somewhat higher prices.

Employment, production, and sales are all on a downward path and indicate spreading weakness in the economy. Total nonfarm employment fell 140,000 last month with declines in construction and manufacturing and little change in the service sector--which had been registering sizable monthly increases. Moreover, the average workweek declined further. The unemployment rate rose 0.2 percentage point to 6.2 percent, with the increase owing mainly to growing unemployment of adult males. Weekly figures on initial claims for unemployment insurance have been moving up for a number of weeks and we anticipate an appreciable rise of the unemployment rate during the current quarter.

Industrial output declined substantially last month, and the previously indicated small rise in February was revised to show a small decline. Cutbacks in output of final products and materials were widespread, and even business equipment, which has been comparatively strong, registered unchanged output. Manufacturing capacity utilization fell nearly 1 percentage

point last month to 83 percent, or about 4 percentage points below the year earlier level. Both output and capacity utilization are likely to fall further in April, influenced considerably by the slashing of assembly schedules for autos and trucks.

Total auto sales declined further in March and sales of domestic models remained quite weak in early April. Sales of foreign makes and some small domestic models apparently are constrained by tight supplies, but sales of intermediate- and standard-size makes have been sluggish despite being propped up by expensive rebate programs. Retail sales other than autos and nonconsumer items declined substantially in nominal terms in February and changed little in March according to the available data. Consumer spending in real terms is likely to continue downward given declining real incomes, the deterioration of consumer balance sheets and tightened markets for consumer credit. Moreover, the oil import levy in a matter of weeks will begin draining off additional purchasing power.

In the housing market, the stresses and strains on homebuyers and homebuilders are well-known. Home sales have plunged and last month starts fell to just over a million units at an annual rate. The staff has revised downward its forecast of housing starts to an average of 900,000 units at an annual rate this quarter and next, and should this forecast materialize, it would represent the lowest quarterly average level of starts in the post-war period. The forecast does not take account of administration initiatives announced a few days ago which would lower interest costs for those eligible, and these programs could add a little to starts in the second half of this year.

The business investment sector is also evidencing signs of weakness. Fixed investment spending in real terms increased slowly in the first quarter while inventories are estimated to have been about unchanged. Indicators

of future investment activity generally have been flat or moved lower, and there have been some reports of postponements of planned investment projects. The downward pressures on investment expenditures should intensify with declining sales and profits along with the tight financial position of the corporate sector in the aggregate.

On the price side, inflation has continued rapid although there are more signs of a cyclical response to sluggish markets. Prices of industrial commodities have been rising much less rapidly or, in a number of cases, actually dropping. Food price performance has been quite good in recent months, aided in part by increased beef and especially pork production. While food prices are expected to be rising somewhat more rapidly during the second half of the year, by then energy price increases are likely to be slowing considerably and the mortgage cost component of the CPI is projected to be declining. As a result, the CPI is projected to be rising late this year at roughly half the 17 percent annual rate expected in the first half of the year. Further progress in slowing inflation is projected in 1981 in an environment of sluggish product and labor markets.

The staff forecast contains a fairly severe recession, which persists longer than usual and is followed by a weak recovery. These characteristics stem in part from our reading of initial conditions, such as the poor financial status of the consumer sector and rapid inflation. But they also importantly reflect the policy assumptions. Both monetary and fiscal policies are assumed to be tight throughout the projection horizon, with tax policy in particular now set for substantial increases in tax burdens both this year and next.

FOMC Meeting
S. H. Axilrod
April 22, 1980

The recent, unexpected decline in narrow money, and sharp slowing in broader measures of money, raises questions about the relationship of the Committee's money growth targets for the first half of 1980 to prospective interest rate levels over the weeks ahead and about possible policy implications of any changes in that relationship. I would judge that the recent shortfall in money growth has increased the odds that interest rates over the weeks ahead could drop substantially further if money growth is to be placed back on the Committee's track between now and mid-year. If that does indeed tend to be the outcome, the Committee may want to consider whether on policy grounds it should maintain the aggregate path and let interest rates drop off to say, the bottom of the existing 13 to 20 percent range, or even lower, or whether it should lower its path for the aggregates--as defined currently by an M-1A increase of 4-1/2 percent, or somewhat less, from December to June.

Of course, the Committee may not in practice be confronted by such a choice. There are some non-trivial odds that money growth will rebound at around current interest rate levels. Nominal GNP is projected to rise at about an 8-1/4 percent annual rate in the second quarter. Some growth in narrow money is probably required to finance that increase. Our quarterly model would call for a quarter-over-quarter rise of 6 percent or so, even after allowing for the restraining effect on money demand of earlier interest rate increases, but our monthly money market model would have substantially lower growth. Judgmentally, we have assumed that quarter-over-quarter growth at around current interest rate levels would be on the order of 2 percent. If the public does want to increase their holdings of money this quarter by that latter amount, then money growth in May and June will turn out to increase by about an 8 percent annual rate.

Should a rebound of something like that not occur, the Committee may be faced with the policy issue of either reducing its aggregate target or letting interest rates drop substantially further. Two main arguments can be made for lowering targets for the aggregates. One would be that the decline in narrow money represents a one-time demand shift in response to the surge of interest rates in late winter and early spring. If such a demand shift were ignored, achievement of the previously targeted rate of growth in money would represent an easing of monetary policy.

Thus far, however, there has been little empirical evidence of a demand shift. For this to have occurred, there ought to be some at least partially offsetting rise in substitutes for cash that are contained in broader measures of money. But in March and early April, there has been a noticeable slowing of increases in the interest-bearing components of M-2 and M-3--the opposite of what would be expected if a demand shift was in train. Of course, money could be moving out of demand deposits to such financial assets as Treasury bills, but we do not have data beyond February for our broad measure of liquidity (L).

Another argument for lowering the monetary aggregate target for the first half of the year would be if the Committee believed that was necessary to forestall a significant further decline of interest rates that might be interpreted by the market as premature ease by the Federal Reserve and hence lead to a worsening of inflationary psychology--or might at least limit the improvement in the inflationary outlook that could be obtained by holding market rates for a while longer. If the Committee chose this approach of lowering its December-to-June target, it might imply a sharp reduction of interest rates later in the year as efforts are made to move back toward the

midpoint of the longer-run target for the whole year 1980. Thus, unless the Committee were to lower the target for the whole year 1980, the issue before it under the assumed circumstances is one of timing in interest rate movements--whether to permit a decline sooner or to wait and expect a probably somewhat more substantial decline later.

There is one main argument for the Committee's adhering to its previously set monetary target for the December-to-June period, and letting interest rates drop substantially further should market forces bring them down. Adherence will automatically result in a counter-cyclical reduction of interest rates as economic activity declines and the transactions demand for money slows. Also, adherence would guard against a rise in interest rates during a period of weakening economic activity should there be a transitory pick-up of money growth in the forthcoming weeks, as could develop unless the second-quarter GNP turns out to be even weaker than projected.

There are risks to either the approach of lowering monetary targets or of maintaining them and letting rates go. If the monetary target for the December-to-June period is lowered, interest rates could actually go up in the short run or go down very little, when the economy seems clearly to be weakening. There may be some benefit for reducing inflationary psychology and in the short run to maintaining the value of the dollar in exchange markets from such an approach, but perhaps at the cost of recession and of some weakening in the posture of fiscal restraint. If, on the other hand, the monetary target for the current six-month period is maintained and interest rates do drop sharply further, the recession would be moderated, but at the cost of weakening efforts to reduce inflationary psychology and perhaps of making it difficult not to be above desired monetary growth for the whole year 1980.

The Committee can adjust its monetary growth targets and federal funds rate range to take account of its assessment of the risks involved. For instance, the Committee might set the money growth target at the highest rate that it finds tolerable for the period between now and mid-year if it wishes to minimize the changes of an interest rate increase in the weeks ahead. At the same time to guard against an abrupt decline in rates the Committee could set the lower limit of the funds rate range also at the highest of the various lower rates that appear reasonable--that is at the rate below which the Committee was not prepared to go in the short run without, say, considerable weakness in the aggregates below the specified money growth rate and without further consultation.